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investing ON THE go

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[INTRODUCTION]

Staci West (SW): Welcome back to the Investing on the go podcast brought to you by FundCalibre. With interest rates rising, inflation proving stubborn and technology giants borrowing billions to fund AI, fixed income investors face a changing landscape.

Darius McDermott (DM): Hello I'm Darius McDermott. I'm delighted to be joined by Jerry Wharton who is the fund manager on the IFSL Church House Investment Grade Fixed Interest fund. Jerry, how are you?

Jerry Wharton (JW): Very good, thank you. Very good to see you today.

[INTERVIEW]

DM: So, let's start with just a little reminder to our listeners as what it is you're trying to achieve the fund.

JW: Okay. Well, this really is an investment grade fund for a start, as the name implies. Some investment grade funds aren't necessarily purely investment grade, but we are, and that's a hard rule.

DM: So that's no high yield at all?

JW: No high yield at all. If anything has a single high yield rating, we can't own it in this fund. If anything goes to high yield, we can't own it and there's no dustbin for junk credits, there's no grace period, it has to go straight out of the fund. So you can rely absolutely on the discipline of this being an investment grade fund.

It's coming at the asset class from a higher quality perspective than many funds in the area. And this is because, initially the fund was, started for use by our private clients, within our private client portfolios, and that's still what it's used for and it's used by other people within private client portfolios or their own

portfolios. And we think we come to a fundamental, driver behind the fund, and that is to avoid undue volatility within the asset class.

What firm believers that, especially within a private portfolio that, volatility — undue volatility — is not what people should be seeking within this asset class, because if you want it from other asset classes, you can get as much volatility as you want.

DM: You can get more volatility if you like.

JW: Yeah, we know from our own experience with our private clients that, you can sit there having a conversation with them about their portfolio, and they understand volatility from the equity part of the portfolio, but they don't understand — and they simply don't want — and we don't think it's necessary to have to endure volatility from their fixed income allocations. So we seek to avoid it and we like to think over time, the mandate of the fund is very much validated, how the fund has performed through some very difficult periods.

DM: Well, 2022 is the obvious sort of, proof, if you like, of that.

JW: It's the most recent one. And, for me that was, 1994 all over again when the Federal Reserve aggressively hike rates all year, and all central banks hiked in 2022. And coupled with, spreads widening which tends to happen in a hiking cycle, you know, it's very destructive and very volatile for some of the funds in the asset class. And I would say that if you look at the sterling corporate bond sector as a whole, most funds are still negative post 2022. They haven't got back to where they started, and whereas we are well above where we were going into 2022. So if you can contain the downside in this asset class, it helps you to recover very quickly and to harness the upside. And it's a fairly straightforward way of looking at it, is that, you know, if you lose 20% in this asset class, let's say you make 20% back in a hurry because you don't, you know, it's not the nature of it.

DM: Well, one of the tools that all fixed income managers have to lower volatility is duration. I think the last time we did one of these, you had a shorter duration. What's your view on that at the moment and how is the fund position on that sort of, interest rate risk side?

JW: Okay, well at the moment we're still relatively short. We're about 3.7. I think that we spent last time we were 3.5 [**DM:** Right. So fairly similar then] So similar. We've edged that a bit and I'll explain how we've done that in a minute. But, this is not a short duration fund. This is a fund that can be short in duration.

DM: It's one of your leavers, isn't it?

JW: Well it is, and it's due to the fact we're not above bracket size, we can move our duration around quite aggressively. And we have done, and we will do, but for the last few years, people have been trying to take on too much duration again and again and again, and they've suffered the consequences. And we've seen that even in the last few days when, you saw a rally across the curve that, certainly in, you know, people are going, "Oh, thank God I, you know, bought a load of 38 gilts when they're trading at 6%." Well, you know, we, you've only got to have a number like yesterday, so CPI comes out hot and there's some hawkish Fed speed and then suddenly, bang, you know, and duration amplifies those moves, especially to the downside.

DM: So it's not a short duration fund, but it is a tool that you can and do use.

JW: Absolutely. I mean, we use, various, we can settle our longer dated paper, we can use floating rate notes that, which effectively have no duration, within the fund. And we do use those covered bonds, which, a

floating rate over Sonia. But, you know, these are liquid issues. So we can move the fund very aggressively when we need to and as I said, we have done, and we'll do again. But, if you're trying to run a fund that's 10 times the size even more, you know, you don't have the nimble characteristics that we have enable us to move around within the asset class. So as you said, different leaves to pull, but credit quality is another one of them. If you use these cover floating rate bonds, they're all AAA rated.

So to give an example, going into, the end of 2019, early 2020, we thought the, rate cycle was like, the central banks were gonna begin to normalise. We though the credit cycle, was going to turn because spreads are too tight. And then, so we moved up our allocation to, AAA floating rate notes to near to 70%, and went into that period without a single long dated issue. Pandemic came out of nowhere, help, you know, no one knew what was going on. We were very well positioned from a credit perspective, but then it became obvious that rates, were gonna be held low and that the system was gonna be supported by central banks, which it was. So we basically sold just about all of our AAA rated of paper. And we went into the end of 2020 with 25 long dated issues. Our duration had gone out to nearer to 7 [years]. And we then had a very steady 2021.

And then it became obvious that central banks were behind the curve. So what do we do? We pushed our duration right back in, and we ended 2021 without a single long dated issue again, waiting for what unfolded. And so we were back up to near 70% of AAA rated assets. And then we saw that the carnage of 2022, not only rates, continue to be hiked, but spreads blowing out all the way until the end of the trust carting disaster. And so we, you know, this is aggressive within the mandate that we have and within the asset class. But the key thing is that, and I really want to make the point that this is not a benchmark fund.

We think the benchmarks in this asset class lead people down the wrong rabbit hole. They end up earning too much duration or they end up not being able to own AAA rated covered bonds because they don't appear in any index. Whereas if you're not benchmarked, you can basically, as long as it's a sterling investment grade entity, we can own it.

DM: Fantastic. So let's talk a little bit about what's going on in the fixed income markets. We got a interest rate rise from the Bank of England to 4% last month. Gilts have been quite volatile, as the sort of, another way some people call it the risk-free asset. Well, it's a risk-free asset if you can hold it forever. But, not for me. But what do you think is likely to happen to rates and how is the gilt market behaving at the moment?

JW: Well, as of, this morning, the Sonia curve, the money markets are still pricing in, another 75 basis points of hikes by, this time next year.

DM: So that would be likely three lots of 0.25% interest rate hikes.

JW: Whether that ends up being the case or not, we'll see. But, what we have seen is everyone came into this year expecting interest rate cuts. And obviously had to pretty quickly, recalibrate, that as obviously, the, Gulf, you know, started taking on its, I won't say too much about Trump really because I can go on and on about it, but, you know, what he though he was doing, I don't know, but it has had a profound effect on everyone and everything and not only his own chances.

DW: But certainly the oil price and the inflation figures.

JW: Well, exactly, you know, and, you look at the Federal Reserve has been above target on the PCCPI for, over six years. So, you know, and we had a tick up yesterday, you know, inflation isn't coming down anytime soon, even though the oil price has moderated quite a lot. You know, you've got to worry about some

embedded inflation and that's certainly what the Federal Reserve is worrying about, which is why they were so hawkish. So, but we'll see.

But at the moment, you asked about the gilt market. The gilt market is functioning. You know, we are, arguably in a better fiscal position than the United States of America, but that's actually not difficult. But, we're still not in a great position. And say, when people get worried about, funding within sovereigns, it tends to be the longer end, you know, term premium has reasserted itself. There wasn't much term premium for a long time. Now people are remembering that if you lend money to people for longer, you actually tend to demand a higher interest rate.

DM: Yes, that's the deal.

JW: That's the deal. And it's nothing new about that. No. So that's something that people have remembered and are now demanding higher yields. But, you know, there's no two ways about it. We're near to 100% debt to GDP. We're in a better position than some of our European friends maybe, but even say, things are not completely bulletproof, from a fiscal perspective, but the gilt market is still functioning normally. It has, a much better, credit worthiness than, say, French bonds, which is, I say, not difficult. In some ways, it has better credit worthiness than US treasuries even though obviously they're in the reserve currency.

But you mustn't forget that what underlies, in fact, both those markets, and I worked in the gilt market, which I think you remember. [**DM:** I do, yes.] Used to work on the sell aside for 14 years, so, I like to think I know what I'm talking about when it comes to the gilt market, but you have a structure of gilt-ish market makers, and they are primary dealers, who have obligations to make secondary market pricing, but also in the primary market, they have obligations, which basically mean that you're, I don't know how you would end up with a failed gilt auction, but it's not gonna happen, because if you don't get enough buyers, martial buyers for what's being issued, the primary dealers have to take it. And so you can't have a failed auction. So when you hear people commenting on that [**DM:** It's a bit of a fallacy.] That's not the market structure. I know it sounds…

DM: Do you have many gilts in your fund today?

JW: We have no gilts. We'll use gilts as a cash alternative. At the moment, we're fully invested, so we haven't got any cash effectively. I've got nothing against any gilts, you know, they're liquid, and…

DM: A decent rate, 5.4% on the 10 year, not that long ago?

JW: Well, absolutely. I mean, these are decent, coupons that you can get, they're decent yields. But you are, well, you're in one sovereign risk, which say I've got no massive problem with at all. But, you are having to go a bit further out than we are to get those kind of yields. And, this feeds into the whole, back into what you're saying about duration and the gilts being risk-free. Well, you know, you tell an owner of a long dated, linker, he lost 90% in the last, you know, hiking cycle, they're not being risk-free about it actually.

DM: No, absolutely. So where are you seeing opportunities? I mean, let's just re-clarify. This is a sterling corporate bond fund that invests in corporate bonds. You can do some gilts from time to time But you're fully invested. Where are you seeing those opportunities and what sort of spread, which is a bit of extra income one can get or expect stroke demand for lending to a company rather than a government?

JW: Well, we've got a live example today. So, a good policy, three year issue from London Stock Exchange Group, which everyone's aware of turned itself into a data provider effectively or data company. And, this is just pricing at 75 basis points over the three year gilt. So it should pay about five and five eighths of a percent

coupon for three year paper, which is A rated. So it's pretty good, you know, opportunity if that's what you want. We own some other, London Stock Exchange paper, which is just slightly longer, and that's paying us 5.7%, so we didn't feel the great need to go to a new one today.

But, you know, further out, we bought a recent bond from Standard Life. This is subordinated bond, so down the bottom of the capital structure. It's a tier two insurance instrument. And, this is notion a 30-year bond, but it has a 10-year call, so you price it to the 10-year call because they will call it. And that's paying us seven and three eight of a percent. So from a coupon perspective, thanks very much. [**DM:** Yeah, lovely.] And we'll take that all day, which slightly feeds into the narrative for not having to go too far out to get those kind of yields.

And if I look across, and I have the fund in front of me, you've probably seen it before, Darius, so we're very transparent in what we do. For most people it's too much information, but it's kind of what we deal with. And we've got, you know, we've gone from a completely different environment where rates were so low for so long, we're trying to maintain a yield was very difficult. Now, you know, we're back into quite straightforward bond investing where we can buy bonds way below par. We can hold them to redemption if you want to and take the capital uplift to those, but some decent coupons along the way.

So to give you a clue about that, we do have, an average price of what we own, across every bond, is actually 95, so way below par.

DM: And again, just to remind our listeners, bonds redeem at par, which is 100.

JW: Sorry, all bonds redeem at par apart from some special ones…

DM: So if you're buying them at 95p, you've got a capital uplift as well as the coupon income that you get throughout.

JW: Absolutely. And that's what we'll do across the fund is that basically going back to 2021 when spreads were incredibly tight all year because of central bank support, benchmark yields were 10, 20, 30 basis points because of central bank support or central bank, policy. It means anything issued, in 2021, is deeply underwater from a capital perspective. There's nothing wrong with it from a credit perspective, but it was just issued at the wrong part of the rate cycle.

DM: That gives you some opportunity.

JW: A huge opportunity. So we can, which we do across the fund, build in capital uplifts by buying bonds that, are way below par. And so to give an example, I, forgive me if I gave this one last time I spoke to you, but we own a bond from Barkley Group, as in the house builder. I know house builders have had some, you know, ups and downs, whatever, but their balance sheet is particularly strong for that sector. They came to market, in August 2021. It was a green bond, and, they issued it basically with a 10-year bond, with a coupon of two and a half percent, which for a house builder was Christmas. They basically borrowed money for 10-years at 2.5%. [**DM**: Yeah. Very low.]

Very low, and, good for them. We bought a chunk, and then we sold it at the end of the year because we knew it was going to suffer, but we sold it for quite a decent profit above par where it will redeem in 2031. We started buying it back at 59p on the pound, so you can see how much [**DM:** Value you were able to get]

Absolutely. And how much, you know, capital destruction was endured by those who could continue to hold it. It's now trading today at 85, so we've already seen some decent uplift. We'll see, but we'll probably hold that one until it gets that draw to par that pulls a par. And I could name many other similar examples. And these are good quality credits. And that's coming back to the characteristics of the fund. You know, you don't need to go into the lower echelons of quality to get some really decent yields.

DM: Yeah. Well, that's, as you said, your area of expertise. Now I'm gonna ask you a question and people think, Darius, you're crazy. Why are you asking a solid fixed income fund manager a question about AI? But nevertheless, I'm going to ask it because a big factor that has changed from the AI CapEx spend is it used to come from the company's own cash generations. These big companies that we've all heard of, Nvidia, Alphabet, you know, they made so much money they could afford to use that cash to go and build the data centres and invest in the AI race, if you like. But now they're having to come to people like yourselves and ask to borrow money to fund this huge expansion. Are we playing in this area or are we, is this a bit of a red flag for you?

JW: We're very concerned at the levels of CapEx, that have been announced. And we'll see how that plays out. You know, it's a classic possibly over investment, you know, within the cycle. We have seen this kind of thing before, and there's, you know, there's validity behind a lot of it. But, to use that word, but it has credence, you know, the circularity of what's going on, is a bit unsettling.

DM: Is there much issuance in the sterling market? Among other big US companies coming and enticing you in, or not enticing you in, but there is opportunity in London in sterling corporate bonds?

JW: Yes. So, go back to middle of February and Google issued a multi-tranche into sterling. I think it was a mere 20 billion. [**DM:** A rather big issue then] Rather big issue. It was, it was six or seven tranches, issued at a decent time, for them, on relatively tight spreads. But a disaster for the investor in the, it's massively underperformed ever since. It's recovered a little bit recently. Had a particularly bad, end of October, which actually the whole hyperscaler complex.

DM: Both equities as well. [**JW:** Absolutely] I mean, people tend to note the equity volatility, but the bonds are there as well.

JW: And you've absolutely made the point that, you know, these are companies that, for a long time, we've been in awe of the free cashflow that they've generated, you know, and, it's extraordinary and, a very good commentator who I, have a lot of time for, noted that they've gone from cash generators to cash incinerators. Which is probably a good…

DM: Well, I've not heard that one before, that's a good one.

JW: It is a good one. It's not mine. I'm recycling it. But, we have seen this, you know, and they're now accessing every single currency that they can possibly find and now going to Asian currencies to try and, issue, into those, areas. But the Google issues are particularly interesting because, if you look at their, 2032 issue, they issued a one and a quarter billion. They issued that at, I think it was 75 over gilts. It's been out to nearly 100 over gilts, and it's near 55 over, sorry, that one. Yeah. And, so for the investor, it's not really a good one, but it was accompanied by, a 2126 issue, so a century bond.

And, without, casting any illusions on, especially on anyone listening to this, I don't think any of us can be around in 100 years. And it's questionable as to whether Google would be around in 100 years in the same form. Or certainly being the credit entity behind those bonds. But they immediately fell out of bet, you know, they've been down to down 15%, whatever, you know, there is no investment case going into 100 year bond,

even when it falls out of bed, because all they're doing is buying volatility. It, you know, it's got a six and a quarter percent coupon, I think it is. And from an investment perspective, it has been a, yeah, sorry, six and one eighth of a percent coupon. And, you know, you can buy it now paying a yield at 6.71, but I can show a load of other bonds that are not 100 year risk that are paying you better than that. So there is no investment case unless you're trying to sort of, satisfy some particular itch that you need to scratch.

DM: So no big lending to the AI companies.

JW: Well, we will do, but so far, it's not been a good investor experience. It's been a great, fundraiser for the, it's been a good source and there's still massive appetite. So we had, a recent Meta bond, and that was huge oversubscribed in sterling. Fine, but there are other things out there. [**DM:** Yeah] And people get swept up in the, enthusiasm at the moment, obviously, but that doesn't necessarily make it a good investment case.

DM: Of course not. So maybe if we could just finish up with a sort of fairly quick answer, but in light of those three interest rates that are priced into the market, why is your approach a good fixed income approach for 2027? Let's finish on a positive.

JW: Okay. Well, I will, just remind people that in 2027, we have certain risks out there. We've still got the uncertainty of what's gonna happen with energy pricing. We've got this AI CapEx story still rolling on. And the implications that has for global growth, because it's been a big driver of maintaining growth, you know, certainly in the US and adding to growth in the US and even in the UK. You've got central bank policy is still uncertain, but at the moment it's looking pretty hawkish. And, you have, potentially, problems in certain parts of, the credit world, but not across the credit world. So we still think there's spreads which have widened out quite a lot from their tights over in the year. So your aggregate sterling spread is, let's call it 110 at the moment, is probably gonna tighten in a bit over next year, so you can get some capital upside from that.

And, certain sectors, which I think you asked earlier, you know, ones to be either, ones to avoid or to be in the various best names within that sector. And one of those is certainly the auto sector, which at the moment is on a bit of a credit trajectory. So you own your VWs, you own your Toyotas, you own your Mercedes, you don't own other names.

DM: Other brands are available, but not available to the Church House bond funds.

JW: That's it. So at the moment, that I've made the point that there's no need to go out and buy a load of duration. As you say, a lot is priced in, but not necessarily all of it. And then you've only got to have a few more high secrets and then, you know, things could, you know, get a bit more ugly. You do have to worry about fiscal situations of, ourselves and the US, but also across Europe, you know, there are all these elections coming along in Europe at the moment, you know, France has calmed down a bit, but it's still a bit of a shocker from a credit perspective. Germany looks unsteady. So you've got those risks, all out there.

DM: So low vol fund in an uncertain world?

JW: I'll make the case that, a high quality sterling corporate bond fund that has 28% of its assets in AAA at the moment, duration of 3.7, an average coupon of 95, paying out just shy of, 5% is what we're paying out, but your yield to redemption is closer to 6%. So, you know, it's giving you what people should be looking for within a portfolio. You know, standalone, I'm sure you can find other things that might pay you a better yield or whatever, but from an allocation within the client portfolio, this is, we think, what people should be looking for.

DM: Jerry, thank you very much indeed.

JW: Thank you.

SW: This fund focuses on high-quality credits and is not managed to a particular benchmark. The aim is to provide a steady, low-volatility, quarterly income stream for investors. To learn more about the IFSL Church House Investment Grade Fixed Interest fund, please visit fundcalibre.com and don't forget to subscribe to the Investing on the go podcast, available wherever you get your podcasts.